FEDERAL RESERVE BANK OF NEW YORK

ANNUAL REPORT 1978

FEDERAL RESERVE BANK OF NEW YORK

March 23, 1979

To the Member Banks in the
Second Federal Reserve District

I am pleased to present our sixty-fourth Annual Report, reviewing major economic and financial developments and this Bank's operations in 1978.

This Report amply describes the overriding need for economic policy in general, and for monetary policy in particular, to restore stability in the purchasing power of the dollar at home and in the foreign exchange markets. Encouragement could be found in the array of domestic and international measures taken toward those ends as the year wore on. But at year-end, strong new inflationary pressures, arising both from growing strains on internal resources and from external disturbances in oil markets, were evident. Success in turning back the inflationary tide will plainly rest on sustaining determined effort over a period of time, building upon the steps taken in 1978.

Within the Bank, the Report is able to point at striking progress toward enhancing the efficiency of our operations. Those results reflect our continuing commitment, shared widely within the entire Federal Reserve System, to do our work at standards of effectiveness, and with an economy of resources, comparable to best business practices. We have been able to act upon that commitment only through the loyal and dedicated efforts of our able staff and officers, and I take pride in the way they have responded to the changing needs of the Bank, its member institutions, and the public at large.

Paul A Volcker

PAUL A. VOLCKER
President

Federal Reserve Bank

of New York

SIXTY-FOURTH ANNUAL REPORT

For the Year

Ended

December 31, 1978

Second Federal Reserve District

Contents:

Sixty-fourth Annual Report
Federal Reserve Bank of New York

INFLATION AND THE DOLLAR IN 1978

Inflation came to be recognized as the prime economic problem in the United States during the course of 1978. Economic activity remained at satisfactory levels. The real gross national product (GNP) posted a gain of almost 4 percent, a vigorous advance for the fourth year of recovery even if somewhat less than in 1977. The pace of the expansion was uneven during 1978, but the year ended on a very strong note. Employment again rose impressively, and unemployment among experienced workers with marketable skills was virtually eliminated. To be sure, the chronic joblessness among minorities and the young remained a serious concern, but substantial progress was made toward the nation's goal of providing employment for all who seek it.

Any immediate satisfaction in these achievements was, however, overshadowed by inflationary pressures that constituted the greatest threat to the sustainability of the expansion and to the functioning of the international monetary system. As aggregate output began to approach levels that put strains on productive capacity, it was perhaps natural to expect some increase in price pressures. But early in the year it was hoped that underlying inflation would not greatly accelerate from the 6 percent rate of 1977. Instead, price increases began to pick up speed as soon as the economy started pulling itself out of its winter difficulties, and by the year-end the overall level of prices was about 9 percent higher than a year earlier.

In the face of this disappointing performance, the dollar continued the downward slide on the foreign exchanges that had begun in the latter part of 1977.

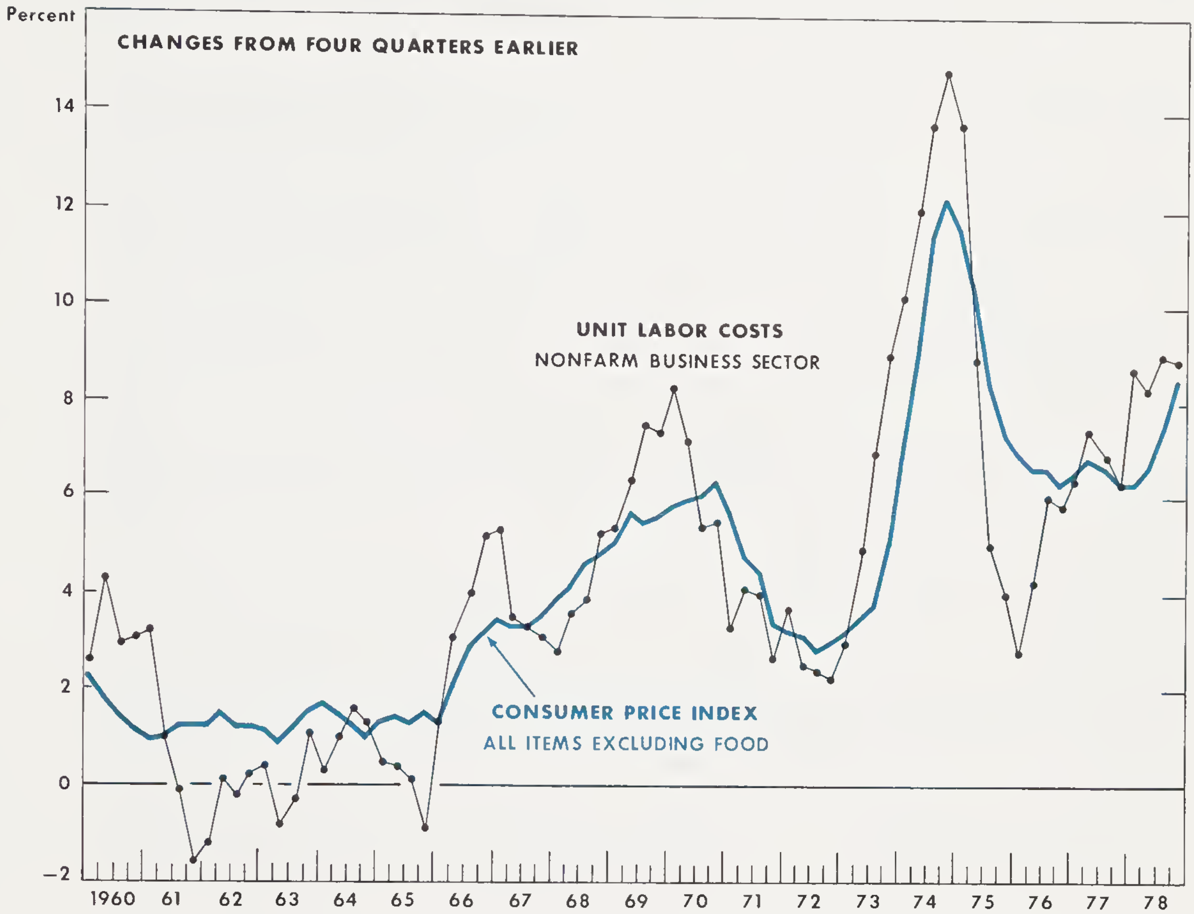
The decline of the dollar, which sometimes seemed to accelerate under its own momentum, reached proportions far in excess of what could be justified as a correction for past, current, or even prospective inflation differentials. Depreciation thus added to the price pressures already at work within the American economy, further complicating the problem of controlling inflation. More broadly, the exchange instability created major disturbances in international financial markets generally, raising new doubts about the future of a liberal trading order.

These clear threats to domestic and international economic stability invoked a forcible response in midautumn when the United States launched major new efforts to deal with both domestic inflation and with the excessive decline of the dollar in the exchange markets. More restrictive monetary policies were a key element in those efforts. The immediate results were highly constructive, particularly in achieving some recovery and stabilization of the dollar abroad. But inflation pressures—recently aggravated further by dislocation in oil markets—remain very strong. The new initiatives, both domestic and international, can only be the first step in the difficult and extended process to unwind inflation. The apparent growing public consensus that restoring price stability must be a prime goal, even if it requires painful adjustments, is encouraging. Our ability to build on that consensus, and to persevere with the disciplines necessary for success in the struggle against inflation, will shape the health of the United States and the world economy for a long time to come.

The Decline of the Dollar Domestically

INFLATION ACCELERATES. The worsening of inflation in 1978 was substantial, however measured. The basic inflation rate, measured by prices of consumer items other than food, rose to 8½ percent over the twelve months ended December 1978, compared with little more than 6 percent over the preceding year (Chart 1). The prices of services increased particularly rapidly as home-owning costs speeded up sharply. Moreover, there was evidence that prospects of continuing inflation had become more embedded in consumers' expectations than ever before, contributing to higher mortgage interest rates and to strongly rising prices for houses.

Chart 1. **PRICES AND UNIT LABOR COSTS**



Food prices, traditionally most volatile and often unpredictable, surged again and jumped almost 12 percent at the consumer level. Some food prices spurted early in the year, as a result of the severe winter, and moderated later on. Toward the year-end, however, bad weather was once again disrupting supplies and driving prices higher. Longer run forces also played a major role in the food price escalation. The most conspicuous increases in 1978 were those in beef prices, which can be reversed only over an extended period because of the time required to rebuild cattle herds. Government policies to protect farm incomes also may have contributed to the overall rise in food costs. In the last two years, the artificial floor under some important commodity prices was moved

upward by legislative actions, and acreage "set-aside" programs were activated for the first time in five years to restrict grain output.

The depreciation of the external value of the dollar imparted a special inflationary thrust to the economy, well beyond what might be expected from the relatively small share of imports in total spending. The rise in import prices resulting from depreciation spread rapidly through the economy because many domestically produced commodities are in direct competition with goods produced in foreign countries. The best-known example of this phenomenon has been the rise in domestic prices of smaller automobiles, which followed upward adjustments in dollar prices of Japanese and European models dictated by declining foreign currency values of the dollar. But the prices of a wide range of other goods, on which the availability of importable substitutes is normally a restraining influence, were similarly affected. In some cases, this restraining influence was also limited by new protective barriers that restricted imports or forced their prices up to higher levels.

Dollar depreciation also appears to have contributed to a new surge in dollar prices of raw materials in general. These prices are determined by supply and demand in the world market as a whole, but the uncertainties about the exchange value of the dollar meant that some purchasers may have turned to commodities as a hedge against future dollar price increases. In any event, dollar prices rose on United States imports of goods for which foreign residents were paying unchanged, or even declining, prices measured in their own appreciating currencies. This inflationary effect applied also to raw materials and other goods in which the United States is self-sufficient or which it exports.

LAGGING PRODUCTIVITY AND MOUNTING LABOR COSTS. Labor cost trends, as determined by the relationship between compensation and the productivity of workers, deteriorated further in 1978. Labor compensation represents about two thirds of production costs in the private business sector and more than half of total Government expenditures for goods and services. Thus, labor costs are a major channel for the transmission of inflationary impulses through the economy.

The growth of labor productivity in the United States began to slow during the latter half of the 1960's. In the five years following the business-cycle peak in 1973, the rate of growth of output per hour worked in private business fell even further to only a little over 1 percent per annum, compared with the

3 percent that had come to be viewed as normal in the first two decades of the postwar period. Typically, productivity has risen faster than its long-run trend during the recovery phase of business cycles. This did happen in the early part of the present expansion—indeed, productivity gains were exceptionally large in the first half year after recovery began in 1975—but the rate of improvement quickly fell back and was unusually low by late 1976. And in 1978 productivity improved only modestly in the private sector as a whole.

This flattening of productivity has a number of explanations. In part, it is attributable to a slowdown in the introduction of new techniques in American industry. Also, in recent years an increased share of capital investment, which might in earlier times have gone toward directly improving the capacity to produce goods, was directed toward environmental protection, health, safety, and other goals the achievement of which is not captured by conventional measures of output. Productivity growth has also been slowed by the shift of economic activity from manufacturing. In manufacturing, it has always been easier than in the service industries to achieve (and to measure) improvements in efficiency. Indeed, productivity in manufacturing posted a good advance in 1978.

The decision by growing numbers of Americans who had not previously participated in the labor force to seek jobs has also contributed to the arithmetic of lower productivity gains. The more plentiful supply of labor has induced some substitution of workers' efforts for the services of capital goods and, with less labor-saving capital to support the average worker, labor productivity has suffered. At the same time, relatively inexperienced, and thus less productive, workers now make up a larger proportion of the work force than before.

The understandable desire to continue to enjoy ever-growing real earnings, combined with increased awareness of the threat that real wages might be eroded by inflation, has for some time exerted strong upward pressure on the compensation levels expected by American workers. In the first years of the recovery union wages led the way, but in 1978, with tightening labor market conditions, wages of nonunionized workers rose almost as rapidly as those of union members. All in all, over the four quarters of 1978, total compensation (which includes wages and fringe benefits) per hour worked in the private business sector rose almost 10 percent, up 2 percentage points from the preceding year.

Government policies contributed to rising labor costs in 1978. An increase in the minimum wage and the rise in payroll taxes, put into effect at the beginning of the year, boosted average compensation by about 1 percent. Further

increases for both the wage floor and payroll taxes took effect at the beginning of 1979.

The combination of very small productivity growth and large gains in compensation resulted in the most rapid increases in labor costs per unit of output since 1974. In private nonagricultural business, unit labor costs rose 9 percent over the four quarters of 1978, sharply higher than the 6 percent increase in each of the two preceding years. In large measure, the rapid cost increases of 1978 were reflected in consumer prices. But that was not the end of the story. Last year's inflation will trigger further wage adjustments for many of the record 8½ million workers covered under formal cost-of-living agreements in collective bargaining contracts. And many millions more workers not covered by such agreements will receive catch-up wage increases. Once started, an inflationary spiral becomes difficult to reverse.

The voluntary program of wage and price restraint announced by President Carter on October 24 is aimed at breaking this vicious circle. The program is designed so that moderation in the growth of labor compensation—which is imperative if inflation is to be reduced—need not penalize workers. Standards for price increases and profit margins, as well as the proposed "wage insurance" plan, are intended to protect the real incomes of working people even as rates of increase in nominal wage levels are reduced. Of course, such a program is no substitute for fiscal and monetary restraint. Nevertheless, widespread conformance to the program would enhance the effectiveness of those more fundamental policies by quickening their effects on prices while reducing the risks of excessive restraint to the economy.

SHRINKING MARGINS OF UNUSED RESOURCES. Government agricultural policies, labor cost trends, and dollar depreciation had all been channels of inflation in the United States well before 1978. In the past year, additional pressures were felt as the economy began to approach full employment of productive resources.

In the earlier years of this expansion the economy had remained notably free of the various excesses and distortions that typically start cropping up as the advance continues. For one thing, the 1973-75 recession had been unusually deep and hence the economy had plenty of spare capacity at the start of the recovery. For another, the severe strains, financial and otherwise, that resulted from the preceding boom imparted a definite sense of caution to business

decision making. As a result, and also because of the general mood of uncertainty, a boom-like atmosphere did not engulf the economy. The expansion proceeded unevenly, to be sure, with occasional pauses as early and minor inventory adjustments were made, but briskly on balance. Even as inflation began to accelerate, the business atmosphere remained generally calm.

The consumer in contrast reacted to worsening inflation fairly promptly. Consumer spending had led the recovery from the beginning, and in 1978 fear of inflation appears to have been a major force behind the continued surge of personal expenditures, particularly on automobiles and other durable goods and on housing. The savings rate went down and borrowings went up, especially on mortgages despite rising interest rates. Residential construction held up remarkably as mortgage credit remained readily available following the introduction of six-month money market certificates with yields tied to Treasury bill rates.

With the consumer propelling the expansion, and capital spending by business also rising, the economy was approaching the limits of potential output as the year wore on. A net 3.5 million persons were added to nonfarm payrolls during the year, an increase of more than 4 percent. By the end of the year, a record 59 percent of working-age Americans had jobs. The unemployment rate declined by nearly a full percentage point from 6.8 percent in the second half of 1977 to 5.9 percent in the second half of 1978. That was of course still well above rates of unemployment during advanced stages of earlier postwar economic expansions, since the labor force continued its extraordinarily rapid growth. Most of that growth consisted of women and teenagers, who traditionally have been unemployed more frequently than adult males. Liberalization of unemployment insurance and other income maintenance programs has also had the effect of keeping the unemployment rate relatively high—at a minimum by enabling unemployed persons to spend more time in the search for suitable jobs. And so, despite relatively high measured rates of unemployment, the labor market tightened noticeably. By the latter part of the year, shortages of workers with particular skills were being reported with increased frequency.

Shortages of some materials, semimanufactured products, and components also came into evidence before the year-end, as margins of unused industrial capacity shrank further. By the fourth quarter, the rate of capacity utilization in manufacturing had risen to 85.8 percent, according to a Federal Reserve measure. Strains on capacity tend to develop at rates of utilization well below 100 percent. In the summer of 1973, for example, the rate had peaked at 88 percent.

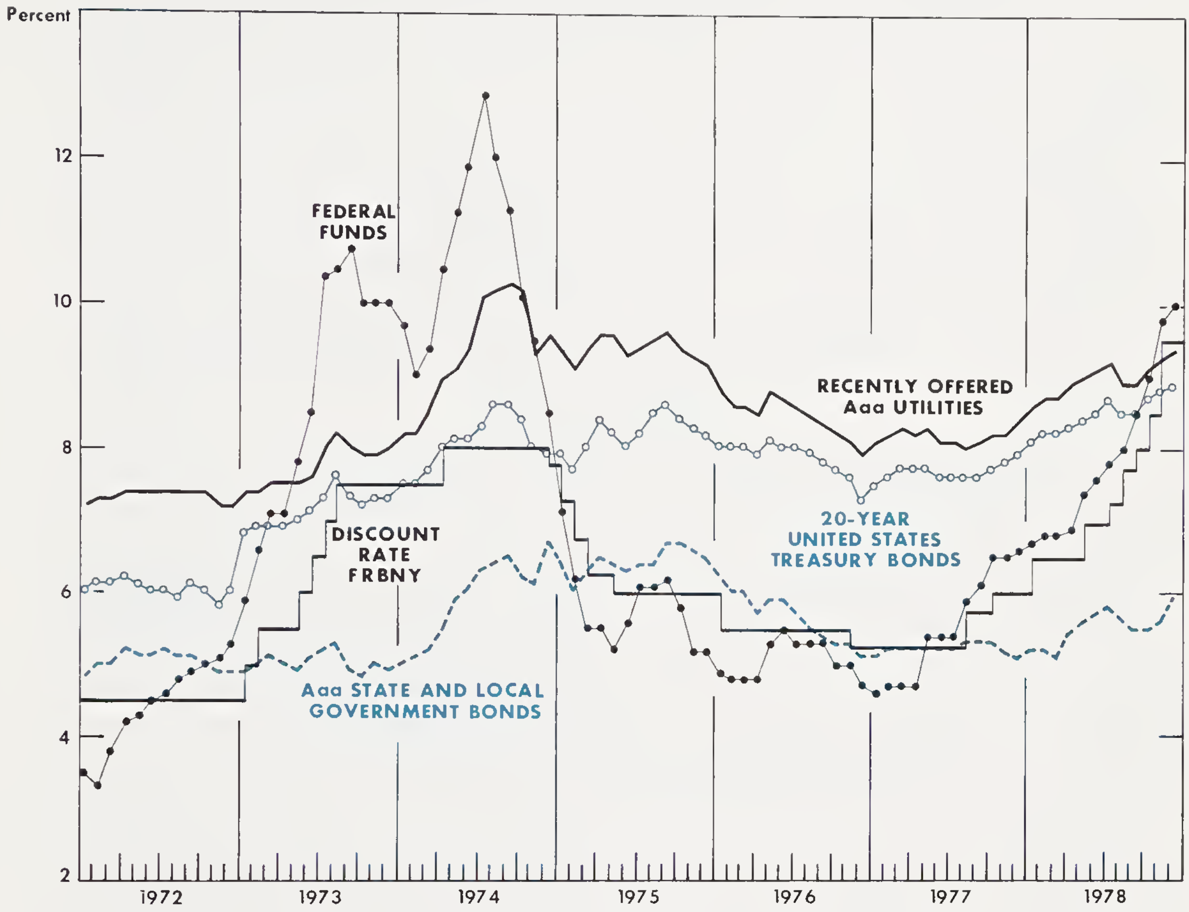
By the end of 1978 there apparently was little efficient industrial capacity left unused in a number of key industries. Economically viable capacity was probably even less than the available measures suggest, because the increases in energy costs since 1973 may have rendered some productive processes and facilities economically obsolete.

BURGEONING CREDIT DEMANDS. The need to finance a high rate of spending on goods and services, as well as brisk turnover of houses sought as hedges against inflation, generated strong demands for credit in 1978. The Federal Reserve—confronted by rapidly growing monetary aggregates, accelerating inflation, and a depreciating dollar on the exchange markets—took a series of steps to resist excessive credit expansion. In this environment of restraint, burgeoning demands for credit drove interest rates to the highest levels since 1974 and, in some cases, to the highest levels on record (Chart 2).

Households were the largest users of credit. The boom in consumer spending through 1978, it is true, was sustained in large measure by rapidly growing household income. To a significant extent, however, it was augmented by stepped-up borrowing by consumers. During 1978, consumer instalment indebtedness rose by $45 billion, representing a 21 percent increase. Mortgage debt of households grew even faster, by $101 billion, exceeding 1977's previous record increase. While the near-record rate of construction of single-family homes was partly responsible for these large demands for mortgage credit, the greater part was secured by existing homes. Record sales of existing homes were stimulated in part by the rapid increases in real estate prices during the past several years. These price increases enabled many households to "trade up" by using the proceeds of the sale of a residence to make the downpayment on a bigger or better one, while often having enough left over to purchase consumer durable goods or to add to financial assets. Others realized capital gains on their homes by refinancing an outstanding mortgage or by taking out a junior mortgage.

Consumer debt burdens climbed to record levels last year, according to various measures. By the end of the year, consumer instalment and mortgage debt together represented a larger proportion of disposable personal income than at any time previously. The lengthening of maturities of some types of debt, especially new automobile loans, somewhat tempered the immediate impact of this growing debt on family budgets. Nevertheless, repayments of consumer instalment and mortgage debt ate up a record share of disposable

Chart 2. SELECTED INTEREST RATES



income. Inasmuch as interest payments are deductible from income for those who itemize deductions in calculating taxable income, the foregoing measures may exaggerate the debt burdens borne by consumers. To some extent, too, increasing debt levels represented a natural outgrowth of the relative shift in the composition of the population toward the 25- to 44-year age group that historically has been the heaviest user of credit. The rising proportion of families with at least two wage earners may reduce the risk of larger indebtedness for those households. Nonetheless, the speculative elements associated with increased consumer indebtedness in 1978 were disturbing, as people attempted to protect themselves from inflation by acquiring appreciating assets and by incurring

debts to be repaid with depreciated dollars in the future. As the year was ending, consumers were beginning to find credit somewhat less available. This was especially true for mortgages, as usury ceilings began to restrict the availability of credit in a number of states.

Credit demands of nonfinancial businesses also rose strongly in 1978. After the winter lull in business, demand for short-term credit surged in the spring to finance a burst of activity, coupled with a resurgence of inflation. Beginning about midyear, the growth of business loans at commercial banks moderated considerably as rising interest rates undoubtedly reinforced business firms' cautious approach to inventory investment. However, while firms were expanding their reliance on bank credit more slowly than before, they were turning increasingly to other sources. During the final quarter of the year, large firms with high credit ratings issued a sizable volume of commercial paper. At the same time, smaller firms were rapidy increasing their borrowing from business finance companies.

Corporate demands for long-term funds also showed little sign of abating during 1978. Net issues of bonds by nonfinancial corporate firms, though well below the record volume of flotations in 1975, were only slightly less than the totals in 1976 and 1977. Moreover, substantial increases in commercial mortgages and in multifamily residential mortgages were recorded.

The Federal Government continued to borrow heavily during 1978, though in lessening amounts toward the latter part of the year. The Federal budget deficit totaled $49 billion in the fiscal year 1978, slightly greater than the preceding year's deficit. The investment in Treasury securities of the bulk of the proceeds of the large-scale dollar support operations undertaken by foreign central banks helped to relieve some of the pressure that the heavy Treasury borrowing might otherwise have placed on the Government securities market. A narrowing of the Federal budgetary deficit in fiscal year 1979, which began on October 1, 1978, was reflected in somewhat lighter borrowing requirements in the last three months of the year. According to official estimates, the deficit is to shrink to about $37 billion in fiscal 1979 and to a targeted $29 billion in fiscal 1980. However, Federal credit demands were augmented during 1978 by an "off-budget" deficit of more than $10 billion—chiefly to finance programs through the Federal Financing Bank—and this deficit is not expected to decline in the foreseeable future. Moreover, Federally sponsored credit agencies borrowed a net of $23 billion in 1978—more than three times the borrowings of the previous year—largely to funnel resources into housing and agriculture.

State and local governments as a whole continued to enjoy large budgetary surpluses last year, though somewhat less than the record level of 1977. Nevertheless, these units issued a record $48 billion of tax-exempt bonds in 1978, slightly more than in the previous year. Part of the 1978 volume reflected special factors. For example, sales of tax-exempt bonds rose to a record volume in August as many issues were rushed to market in anticipation of the September 1 effective date of Treasury regulations intended to restrict "arbitrage" gains of issuers selling tax-exempt obligations and investing the proceeds in higher yielding taxable instruments. Some new bonds were floated to refund older bonds that had been issued at times of higher interest rates.

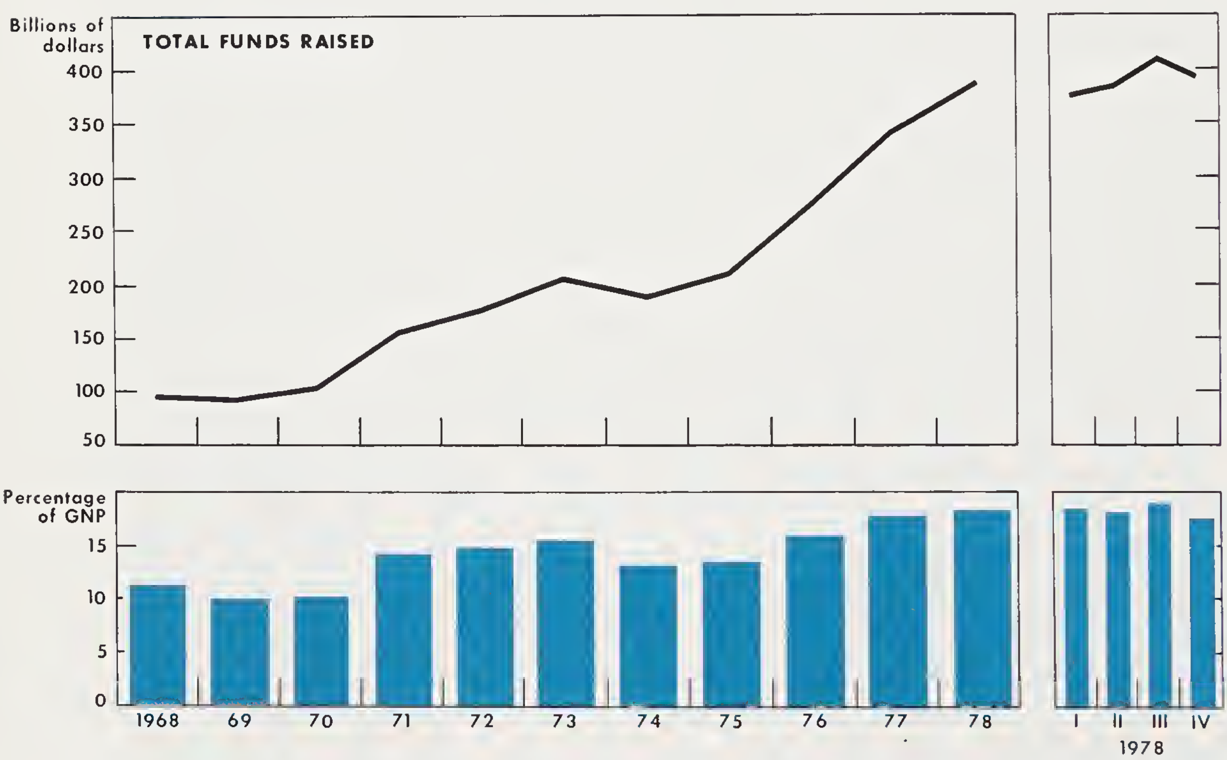
RESTRICTIVE MONETARY POLICY. Strong credit demands were accompanied by rapid growth of the monetary aggregates until late in the year. In January 1978 the Federal Open Market Committee (FOMC) projected growth of the monetary aggregates for the period from the fourth quarter of 1977 to the fourth quarter of 1978 within the following ranges: 4 to 6½ percent for M_1 (currency and demand deposits), 6½ to 9 percent for M_2 (M_1 plus commercial bank savings and time deposits except large negotiable certificates of deposit), and 7½ to 10 percent for M_3 (M_2 plus deposits at mutual savings banks and savings and loan associations). Those ranges of growth were reaffirmed at the April and July FOMC meetings, when the four-quarter projected period was moved forward by one quarter in each case. During the first three quarters of the year, M_1 grew at an annual rate of 8.2 percent, far above the upper limit of the projected range of growth. M_2 and M_3 remained within their respective ranges, albeit toward the upper end.

The growth of the broader aggregates was sustained in part by the introduction of a new type of time deposit, paying rates competitive with rates on open market instruments. Beginning June 1, banks and thrift institutions were authorized to offer "money market" certificates in minimum denominations of $10,000 with maximum rates tied to Treasury bill rates. Commercial banks were allowed to pay an interest rate equal to the average rate of discount for six-month Treasury bills established in the preceding weekly Treasury auction, and mutual savings banks and savings and loan associations were allowed to pay the equivalent of ¼ percentage point more annually. These certificates proved to be very popular. At the year-end, some $23 billion was outstanding at commercial banks and $54 billion at thrift institutions. The new certificates, while cutting

into the earnings of thrift institutions, enabled them to offset the withdrawal of funds from savings deposits stimulated by high yields available on open market instruments. Thus, the certificates helped to sustain the flow of funds into mortgages and to spread the impact of credit restraint more evenly rather than concentrating it on residential construction as happened so often in the past.

The Federal Reserve took a number of overt steps during 1978 to resist excessive credit and monetary expansion. The first such move, an increase in the discount rate to 6½ percent from 6 percent early in January, was particularly intended to complement other steps to stabilize the dollar on the foreign exchange markets. Then during the period from May through October the discount rate was raised five times for domestic as well as for international reasons. By

Chart 3. **TOTAL FUNDS RAISED IN CREDIT MARKETS**
Excluding Financial Sectors



Quarterly data for 1978 are expressed at seasonally adjusted annual rates. Fourth-quarter data are preliminary.

October 13, the discount rate had been raised to a record level of 8½ percent, eclipsing the former record of 8 percent set in 1974. Nevertheless, these boosts in the discount rate generally followed increases in market rates and consequently did not provide strong signals of restrictive policy. A strong signal was given on November 1, when the Federal Reserve raised the discount rate a full percentage point to 9½ percent and imposed a supplementary reserve requirement of 2 percent on large time deposits. These measures were part of a coordinated Administration-Federal Reserve program aimed at restoring confidence in the dollar.

Over the course of the year, the Federal funds rate was increased by 3½ percentage points while other short-term rates rose about 3 to 4 percentage points. Long-term yields experienced increases ranging from about 1 percentage point on high-quality corporate bonds to as much as 1½ percentage points on Treasury bonds, which were marketed in relatively large volume as the Treasury sought to extend its debt maturity structure. Corporate and tax-exempt bond yields ended the year still below their 1974-75 peaks. By late 1978, however, yields on Treasury securities were close to record levels across the maturity spectrum, from near-term bills to bonds that will not mature until after the turn of the century. Home mortgage yields also rose to new highs during 1978. Yet it was not clear whether interest rates had risen enough to achieve the needed credit restraint. With prices of goods and services—and especially values of capital assets such as homes—rising rapidly, even high nominal interest rates still seemed tolerable to many borrowers.

Credit expansion peaked in the third quarter of the year, when total funds raised in the credit markets by nonfinancial sectors rose to 19 percent of GNP (Chart 3). The subsequent decline in the rate of borrowing was not uniform, however. It was centered chiefly in credit demands of the Federal Government, reflecting a strong cash position and a modest movement toward a less expansionary fiscal policy. State and local governments also eased the pace of their borrowing, and net issues of corporate bonds tapered off somewhat. The effects of restraint were very apparent in commercial banking, the sector most directly affected by restrictive Federal Reserve policies. Total commercial bank credit in the second half of the year grew at an annual rate of 7 percent, only about half the rate of expansion in the first half.

At the end of the year, credit demands remained strong but the groundwork was laid for significant restraint. Liquidity positions of consumers, businesses, and financial institutions were declining. There were a few signs of reduced

credit availability. Uncertainty over prospects for business was beginning to discourage overly exuberant commitments. And the growth of the monetary aggregates subsided.

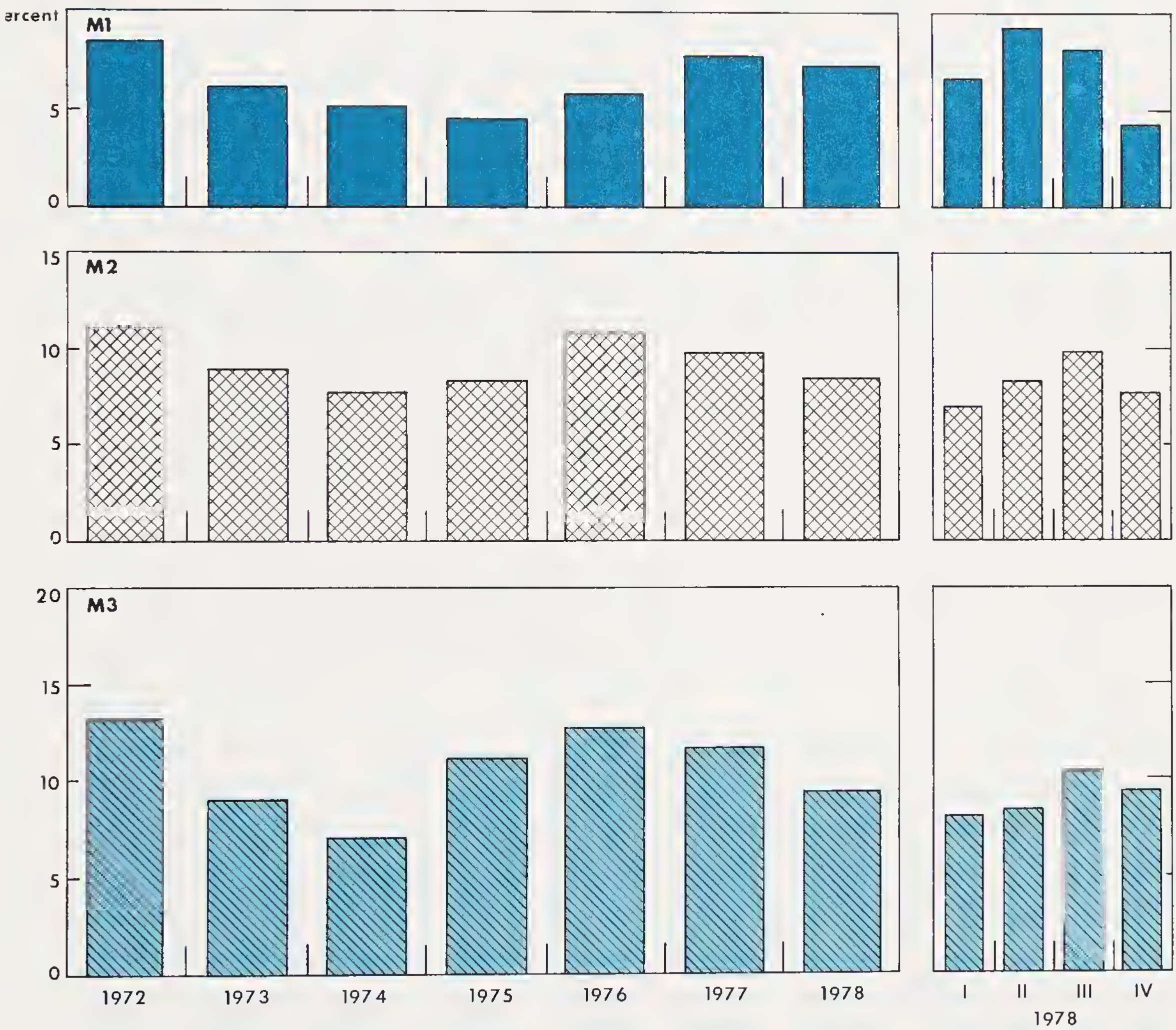
The slowdown of monetary growth was most pronounced for the narrowest version of the money stock (Chart 4). M_1 increased at an annual rate of only 4.4 percent in the final quarter of 1978, compared with 8.2 percent during the first three quarters. The growth of M_2 slowed more modestly to a 7.7 percent rate in the fourth quarter from 8.6 percent earlier in the year. The growth of M_3 slowed only in relation to the rapid expansion of the third quarter. M_3 rose at a 9.3 percent annual rate in the final quarter, down from 10.4 percent in the preceding quarter but above the 8.3 percent growth of the first half of 1978.

In part, the slowdown of M_1 growth reflected the introduction of interest-bearing NOW (negotiable order of withdrawal) accounts in New York State and automatic transfer service (ATS) at banks across the country. Under revised banking regulations that went into effect on November 1, individuals were allowed to authorize their banks to shift funds from savings to checking accounts as needed to cover checks. It is estimated that the economizing on demand account balances stimulated by the introduction of ATS may have reduced the annual growth rate of M_1 by roughly 1 percentage point in the fourth quarter. More generally, rising interest rates and heightened consciousness on the part of consumers and businesses of the interest foregone on idle balances reduced the demand for deposits included in M_1. Liquid assets such as the money market certificates offered by depositary institutions and shares in money market mutual funds proved to be increasingly attractive substitutes for money balances as short-term interest rates rose.

While the effect of the evolving changes in financial management on the demand for M_1 balances was clear, the speed and extent of these changes was uncertain. Consequently, when the FOMC reviewed in October the longer run ranges for growth of the monetary aggregates, the Committee both lowered and widened the range for M_1. For the four quarters ending with the third quarter of 1979, the FOMC established a range of 2 to 6 percent for M_1, while leaving the M_2 and M_3 ranges unchanged at 6½ to 9 percent and 7½ to 10 percent, respectively. After the turn of the year, in February 1979, the FOMC reduced the projected ranges for all three aggregates. For the period from the fourth quarter of 1978 to the fourth quarter of 1979, the projected ranges of growth were set at 1½ to 4½ percent for M_1, 5 to 8 percent for M_2, and 6 to 9 percent for M_3. The FOMC established these ranges in light of its objectives of a gradual

winding-down of inflation and the maintenance of the stronger position of the dollar in the exchange markets, while providing sufficient liquidity to finance sustainable growth in the economy.

Chart 4. GROWTH OF MONETARY AGGREGATES



The money stock growth rates are computed from daily average seasonally adjusted levels in the final quarter of the preceding period and the final quarter of the period covered. Quarterly data for 1978 are expressed at annual rates.

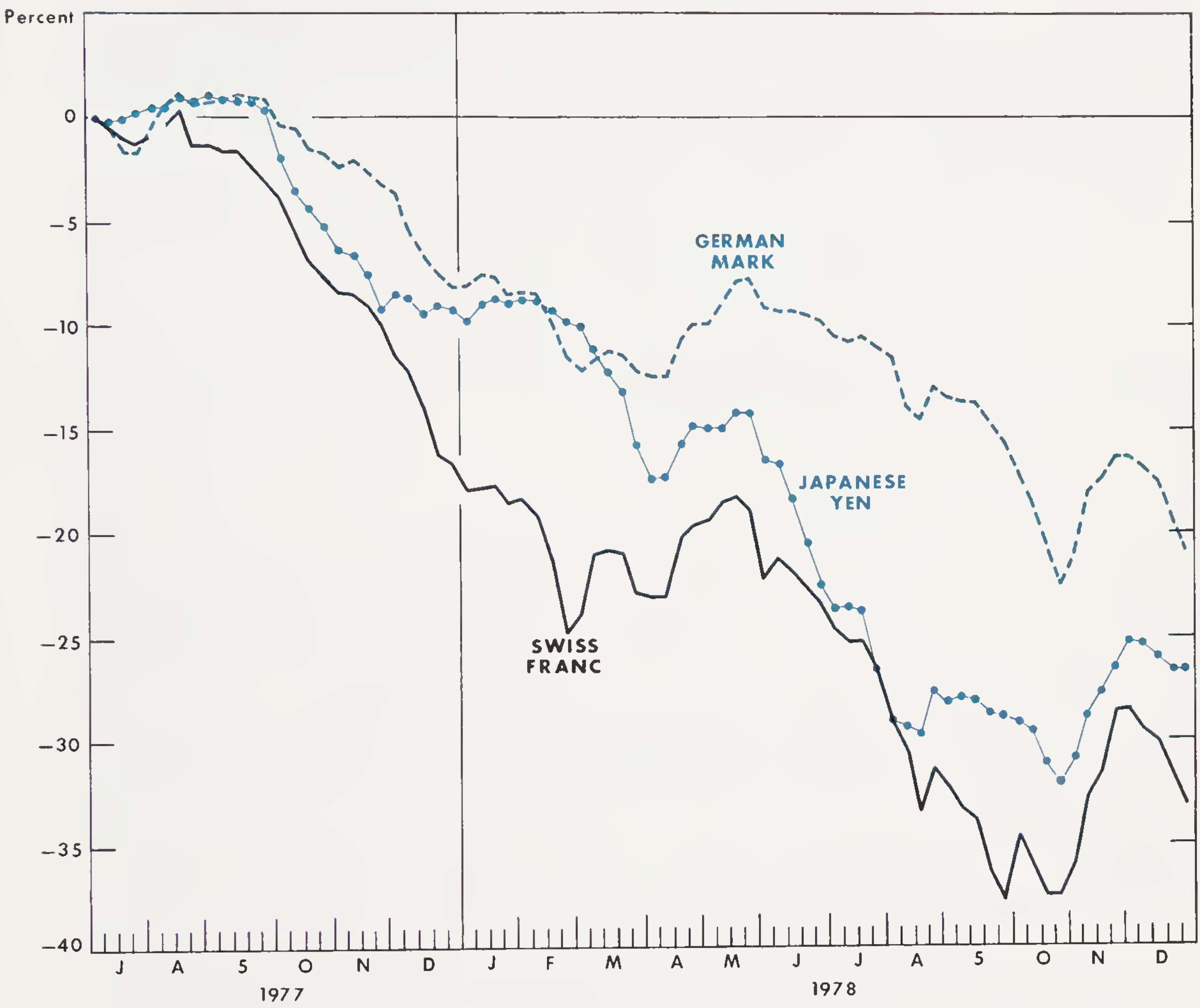
The Dollar and International Adjustment

THE DECLINE OF THE DOLLAR IN THE EXCHANGE MARKETS. The year began with the dollar under generalized selling pressure in foreign exchange markets that had become increasingly disorderly in the latter part of 1977 (Chart 5). Pessimism about the dollar had grown in 1977 in the context of deepening trade and current account imbalances among the major industrial economies, and these imbalances continued to dominate the scene in 1978. As the price performance of the United States economy deteriorated, in major foreign economies inflation rates remained low or were declining. At the same time, economic recovery abroad was generally slow in picking up speed, while the expansion here was proceeding at a good pace. As a result, and because of the initially perverse effects of the dollar's depreciation, the United States balance-of-payments deficit on current account widened further.

Concern over the huge United States deficit was heightened by the unbalanced international payments positions of other industrial countries. As OPEC's (the Organization of Petroleum Exporting Countries) surplus, which had loomed as a major threat to world financial stability in the mid-1970's, dwindled to manageable size, the persistent current account surpluses of three industrial countries —Germany, Japan, and Switzerland—took center stage. The German surplus doubled in 1978 to $8 billion, and the surpluses of Japan and Switzerland increased by one half to $16 billion and some $6 billion, respectively. Simultaneously, France, Italy, and the United Kingdom all achieved further improvements in their international payments which had been plagued by deficits in previous years. Indeed, all but a few OECD (Organization for Economic Cooperation and Development) member countries' current account balances improved during 1978.

As the large United States current account deficit persisted in the course of 1978, market psychology was also influenced by continuing misgivings about the effect of government policies on the deficit and on the corresponding surpluses of foreign countries. Skepticism persisted about United States energy policy as energy legislation made its way through a difficult legislative process to be finally enacted only late in the year. Beyond the narrow questions of energy policy, doubts were also heard about overall United States economic policies, including monetary policy, and the seriousness of the United States resolve to fight inflation. In spite of the concern about a weakening dollar expressed by spokesmen for the Administration and the Federal Reserve, the

Chart 5. **THE DOLLAR AGAINST SELECTED FOREIGN CURRENCIES**

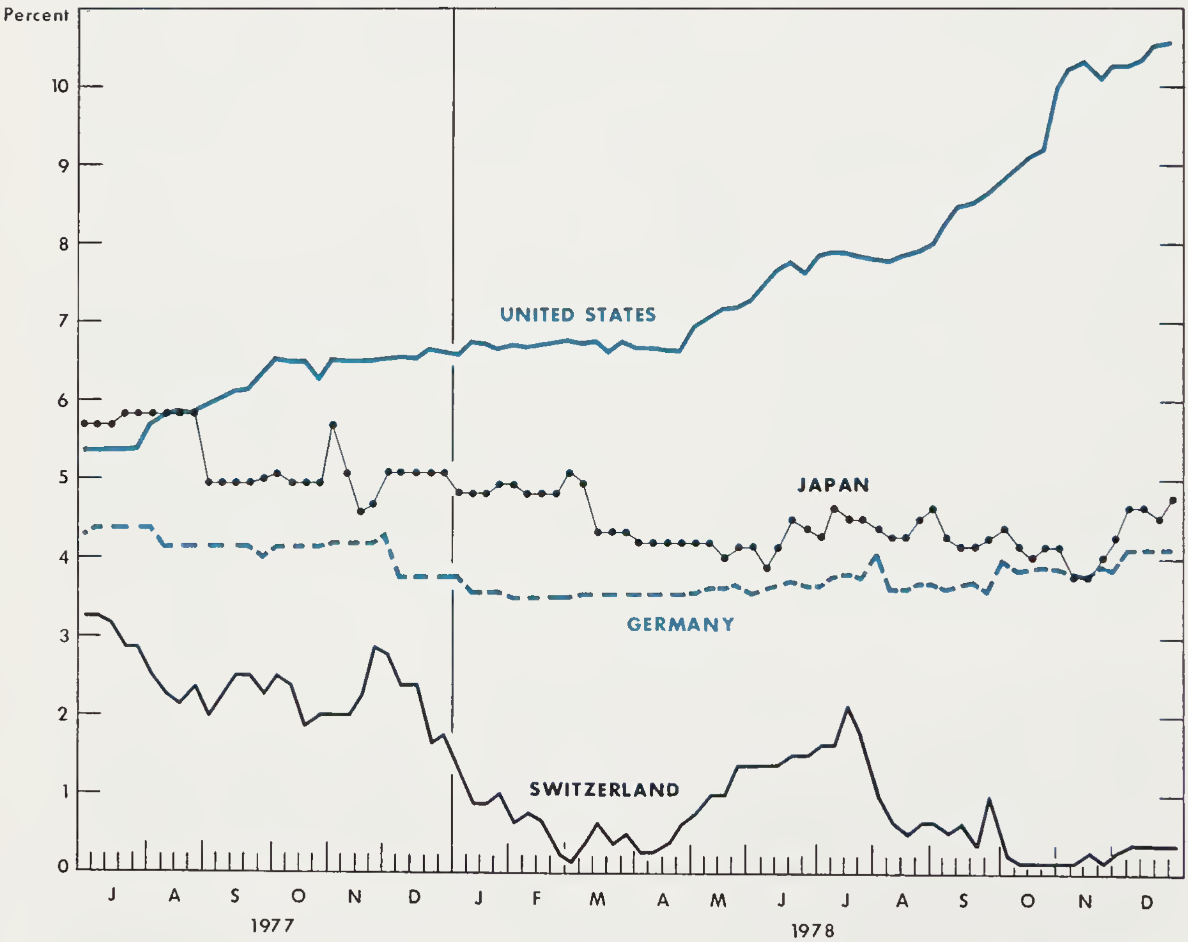


question resurfaced occasionally whether United States authorities were indifferent, if not welcoming, in their attitude toward dollar depreciation. All in all, the credibility and coherence of United States economic policies became a serious issue for holders, and prospective holders, of dollars.

With the huge volume of dollar assets that is now in the hands of both private and official foreign holders, even a small change in views on the desirability of holding dollars can have a large impact on exchange markets, larger than fairly major shifts in current payments flows. In the last few years, some holders

of dollars have sought to diversify the currency composition of their foreign exchange portfolios. Even though the bulk of international currency holdings is still held in dollars, some shift of this sort in preferences at the margin may have been an inevitable result of the changes both in the international system and in the relative economic position of the United States. But the manner and rate at which diversification is carried out is by no means predetermined. In any

Chart 6. SHORT-TERM MONEY MARKET RATES



Rates shown are: for the United States, dealer offering rate for prime commercial paper of 90 to 119 days' maturity; for Japan, rate on unconditional call money; for Germany and Switzerland, three-month interbank rate.

short period, decisions of this kind are highly sensitive to fluctuations in prevailing sentiment toward the dollar.

In periods of comparative calm, interest rate differentials are a powerful force affecting movements of funds between currencies, whether for reason of portfolio diversification or any other. As United States interest rates climbed while those in most other major centers changed little or even eased, interest rate differentials in general strongly favored the United States (Chart 6). The effect of these differentials, however, was swamped for a time by the bearish sentiment that grew against the dollar. The resulting heavy outflows of capital took all forms, including shifts in leads and lags in commercial payments against the United States—a speedup in foreign currency purchases with dollars, and delays in foreign currency sales.

THE NEW COMMITMENT TO DOLLAR STABILITY. Early in 1978 the United States authorities took a number of steps to counter the disorder that had developed in the exchange markets in the last weeks of 1977. On January 4 the Federal Reserve and the United States Treasury announced a shift to a more open and forceful intervention approach in the exchange markets than had been followed in previous months. And swap facilities with the German Bundesbank were enlarged as part of a broader agreement between the United States and German authorities on close cooperation in the exchange markets. This commitment to a more active defense of the dollar by the authorities, combined with a further move toward monetary restraint by the Federal Reserve, succeeded in easing the pressures on the dollar for a time.

In the late spring and early summer, however, bearish sentiment resurfaced, and by late July the dollar was again under widespread selling pressure. As pessimism toward the dollar deepened, the market became increasingly one way and dollar rates plunged to record lows against several currencies, exceeding any levels justified by underlying economic conditions. By the end of October, the dollar was down 26 percent from the start of the year against the Japanese yen and the Swiss franc, and 18 percent against the German mark. The dollar also fell sharply *vis-à-vis* other major European currencies. Only against the Canadian dollar, among major currencies, did the United States currency rise in value.

The dollar's decline threatened to undermine United States efforts to curb inflation, to undercut policies of foreign governments to stimulate domestic

growth, and to throw the international financial system into disarray. More broadly, the decline could, rightly or wrongly, be interpreted as a symptom of weakened United States capacity for leadership, with implications for the stability of the world political structure. Consequently, on November 1 President Carter announced the mounting of a major new effort, in coordination with the authorities of several other industrial countries, to restore order in the exchange market and to correct the excessive decline of the dollar. The program featured a further tightening of monetary policy—highlighted by a 1 percentage point rise in the discount rate and a boost in reserve requirements—and the mobilization of foreign currency resources totaling up to $30 billion to finance the United States part in coordinated exchange market intervention. Among the financing measures, the Federal Reserve swap network with foreign central banks was expanded by $7.6 billion, and the Treasury drew $3 billion from the United States reserve position in the International Monetary Fund (IMF), sold $1½ billion of special drawing rights for foreign currencies, and disclosed plans to issue foreign-currency-denominated securities up to $10 billion.

The program was well received in foreign exchange markets and in United States financial markets generally. The dollar rebounded sharply in the first days after the announcement of new measures, and by mid-November good two-way trading conditions were restored. Subsequently, the dollar declined again amid fears that United States inflation had still not been brought under control, new uncertainties about the availability of oil and the increases in its price, and fears that the United States was rapidly using up its resources in heavy intervention. In fact, however, the United States authorities needed to use only a part of the resources that had been assembled to support the dollar. Indeed, with the turn of the year, the markets were coming into much better balance, and scattered signs were appearing that part of the previous outflow of funds from the dollar was being reversed.

THE BURDEN OF PETROLEUM IMPORTS. Our enormous imports of petroleum products have placed a heavy burden on the United States current account. These imports declined only slightly in 1978—to $42 billion—from the record $45 billion pace of the year before, largely reflecting the availability of new production from Alaska. At the time of the oil price revolution, it had been widely expected that the United States would be less affected than other industrial countries by the dramatic increase in world oil prices. The United

States is one of the world's major oil producers, and its relatively heavy use of oil for consumption, as opposed to production, purposes seemed to provide it with greater scope for conservation. So far the experience has belied those expectations.

Since the early 1970's domestic crude petroleum production has declined and, as a result, United States imports have risen more than consumption. The United States, it is true, has made relatively good progress in reducing *total energy* use per unit of output throughout the economy. Use of *petroleum* per unit of real GNP, however, has declined only slightly, in contrast to sharper reductions in other countries. This is in part because most other oil-importing countries have on balance been substituting other energy sources for oil, while the United States has not; in fact, some switching into oil has occurred on balance over these years, mainly from natural gas. But a large part of the difference is due to the heavier American reliance on road transportation.

America with its vast distances became greatly dependent on the availability of low-cost gasoline. Today transportation accounts for over half of petroleum use and for one quarter of energy use in the United States, far higher than the proportions in Europe and Japan. Transportation, particularly automobile transportation which is disproportionately important in the United States, is a sector in which energy saving has been very difficult in all countries. Although the increase in American energy consumption for transport has in fact been comparatively moderate, it has been large enough to offset the steady reductions achieved in industry energy use. These reductions have compared favorably with those in other countries, both in absolute amount and in relation to overall GNP growth.

It has been clear for some time that a substantial reduction in the country's dependence on imported oil would not be easy to achieve but that the task would have to be approached both from the production and the consumption side. The steps taken so far did not have much effect on United States oil imports in 1978, but they may be expected to yield benefits in the future even though the energy bill finally enacted in October was less embracing than the Administration's original proposal.

The legislation did provide for the gradual raising, and eventual abolition, of ceilings on prices charged for natural gas that have discouraged domestic production and thus added to requirements for imported petroleum. A special "gas guzzler" tax was imposed on large automobiles that are particularly inefficient in fuel use. This will complement the effect of the new car mileage stan-

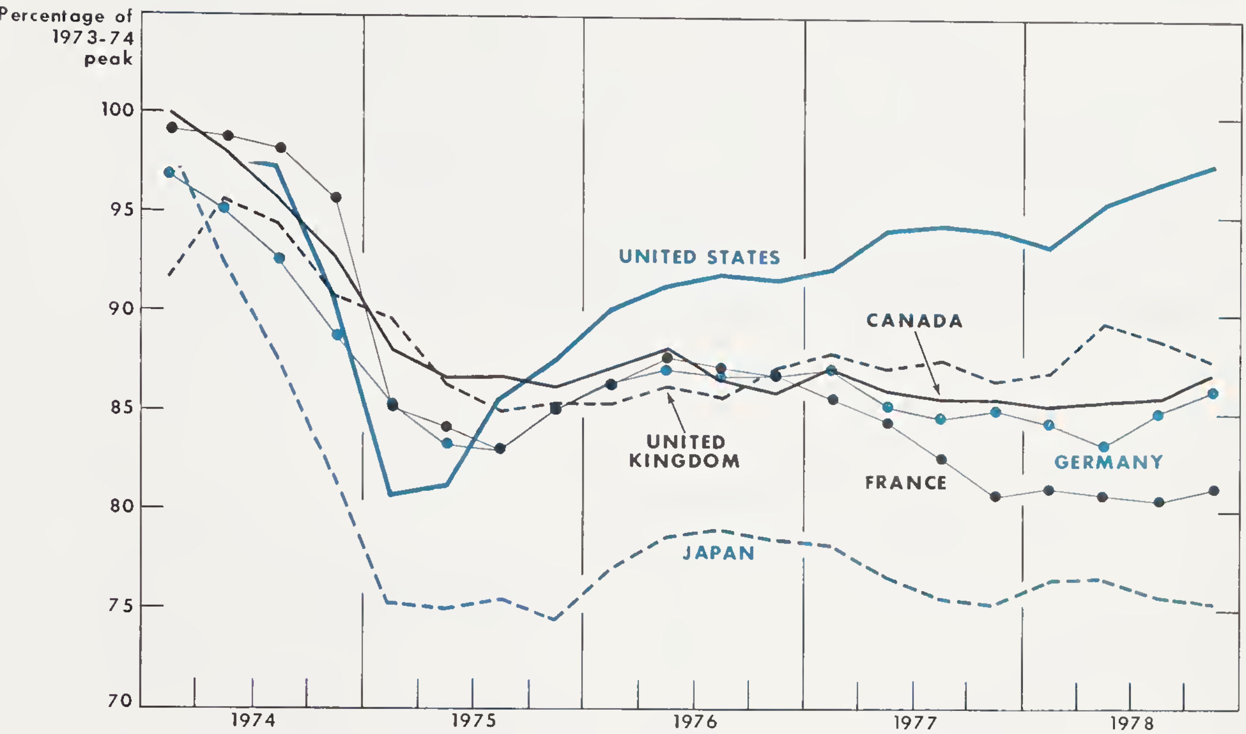
dards, imposed by the Environmental Protection Agency over the last several years, in reducing the United States large petroleum requirements for transportation. As higher prices continued to reinforce conservation efforts and where possible facilitate higher domestic production, further progress in lessening our reliance on foreign petroleum seemed feasible. Nevertheless, as 1978 ended, the question remained whether further major policy changes were needed to accelerate the process.

BUSINESS-CYCLE DIFFERENCES. The United States current account position continued to be adversely affected through most of last year by the disparity in the tempos of the cyclical expansions here and abroad. As the consumer continued to propel the United States economy in the fourth year of expansion, consumer demand in foreign industrial countries by and large showed little vigor. Personal savings rates remained high in 1978 in Germany and other foreign countries in contrast to the United States.

The difference in economic trends abroad was most visible in the slackness which continued to exist in the use of productive resources in industrial countries outside the United States. Unemployment rates again failed to decline from their historically high levels, and in some countries even rose further. Similarly, utilization rates of industrial capacity (Chart 7) edged off again in 1978, as they did in 1977, to levels no better or even below the worst recession levels recorded in early 1975. The widespread existence of unused industrial capacity necessarily dampened enthusiasm for new capital investment, which has remained weak throughout the current recovery abroad. The low capacity utilization rates in the foreign industrial economies had a particularly damaging effect on United States exports by depressing demand for that mainstay of our sales abroad—capital goods, which have accounted for some 30 percent of nonagricultural exports over the last ten years. At the same time, the continued excess capacity spurred foreign producers to extra efforts to supply goods at competitive prices to the American market and to the markets of the developing world.

In the latter part of the year, signs of the long-awaited pickup in the pace of economic activity abroad became more visible. New measures of fiscal stimulus, announced by the governments of Germany, Japan, and other United States trading partners after the July "summit" meeting in Bonn, added support to recovering growth of those countries, although most of the effect was not expected to be felt before 1979. However, at the close of 1978 the indications

Chart 7. **UTILIZATION OF INDUSTRIAL CAPACITY**



Federal Reserve Bank of New York staff estimates for foreign countries and Federal Reserve Board's index for the United States. All data are seasonally adjusted.

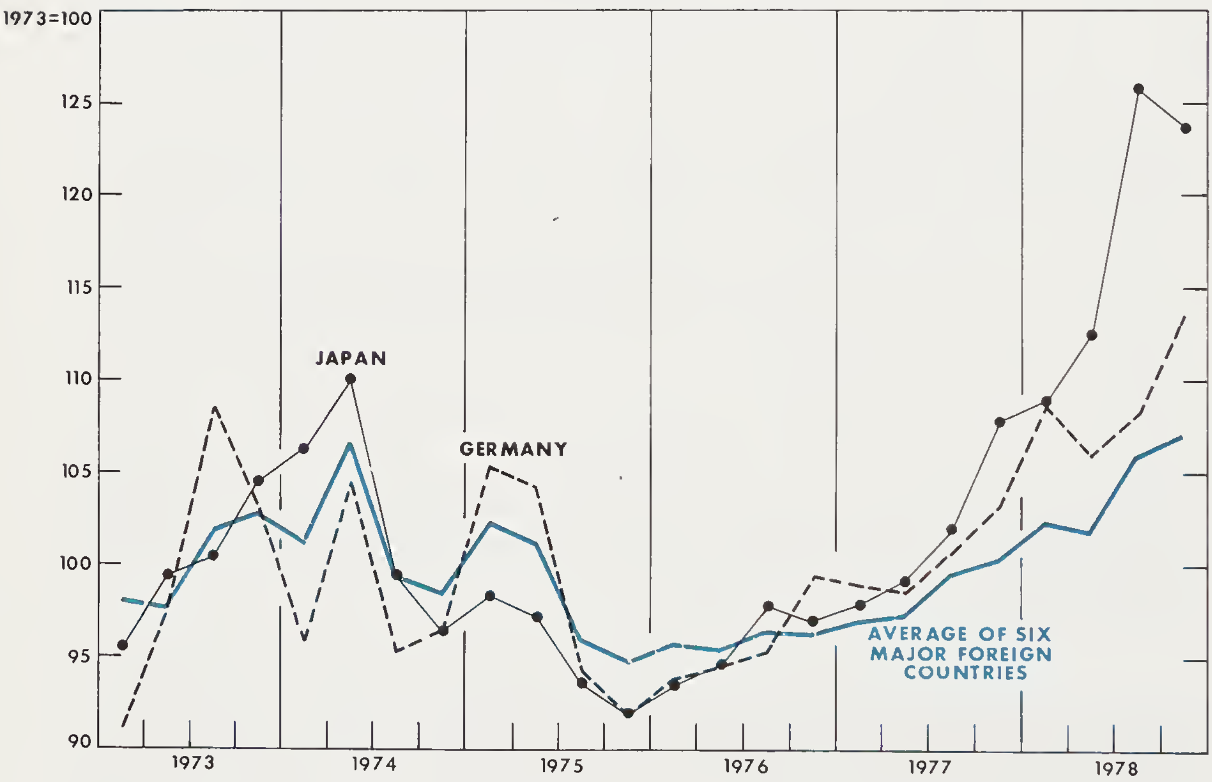
were that, with the prospective slowdown of the United States expansion in 1979, the earlier divergence in economic growth among the industrial countries was finally ending.

UNITED STATES PRICE COMPETITIVENESS RECOVERS. In the 1970's the ability of United States industry to compete in world markets has been influenced by substantial swings in comparative price levels, as both dollar exchange rates and relative inflation patterns here and abroad shifted rapidly. Competitiveness in international markets is of course importantly affected by other factors, including export financing, taxation, and other policies. Over the longer run,

however, changes in relative prices adjusted for exchange rate movements do have a major impact. For a time after the beginning of floating exchange rates in early 1973, the overall rate of United States inflation was somewhat lower than foreign inflation, on average. This complemented the effect of the 1973 dollar depreciation and led to a marked overall improvement of United States cost competitiveness during 1973 and much of 1974 (Chart 8).

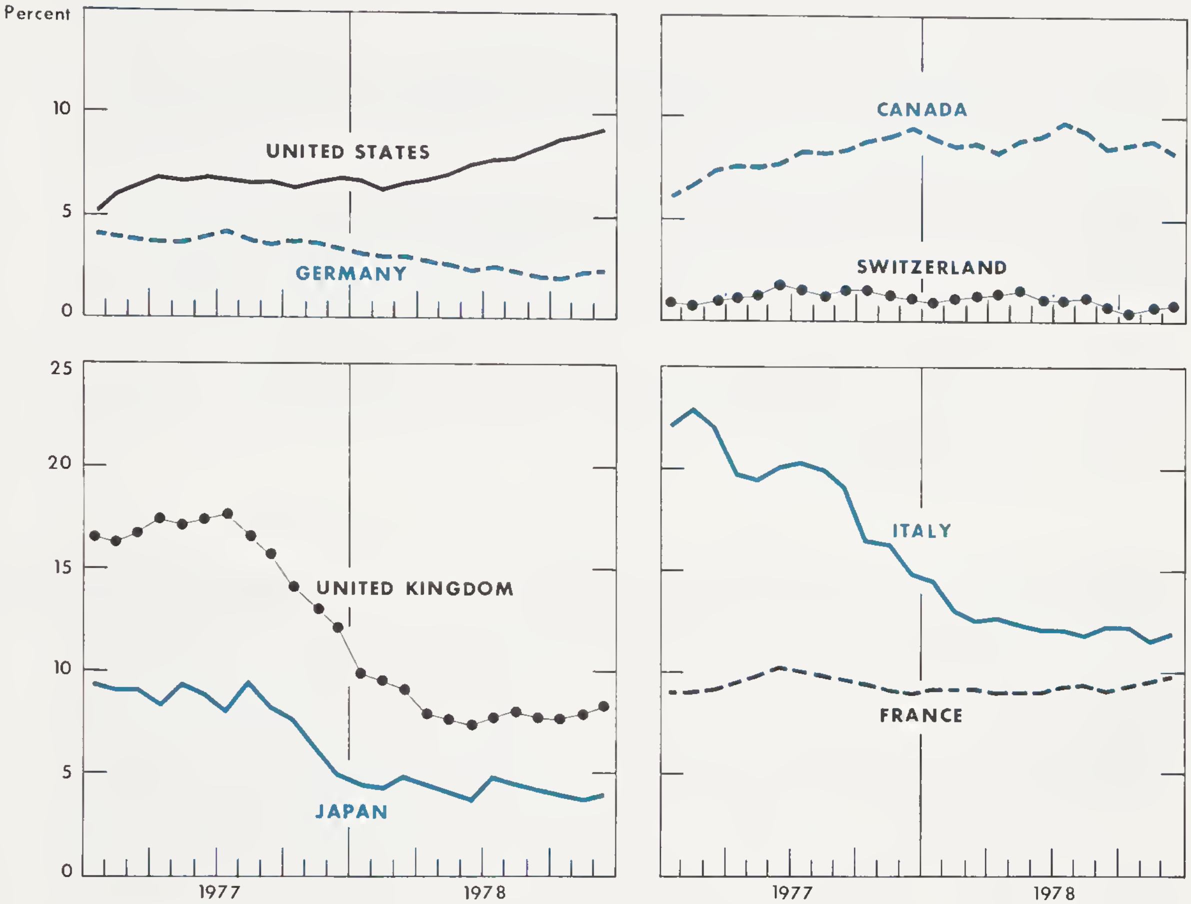
But this relatively favorable United States price position was partly reversed in 1975 as the dollar appreciated. At the same time, unfavorable cyclical conditions gave foreign producers not only far stronger markets in the United States

Chart 8. UNITED STATES PRICE COMPETITIVENESS



This indicator of changing price competitiveness is a ratio of wholesale prices, measured in dollar terms, of competitor countries to United States wholesale prices. An increase in the ratio suggests an improvement in United States competitiveness and a decline, a worsening.

Chart 9. **INCREASES IN CONSUMER PRICES**



Annual rate of change from twelve months earlier.

than American firms had abroad, but also extra incentives to search out profit opportunities in international markets in general to compensate for the weakness in their own domestic economies. Largely as a result, the United States trade position deteriorated from a surplus at an annual rate of $9 billion in the fourth quarter of 1975 to a $48 billion deficit in the first quarter of 1978.

The worsening inflation in the United States during the past year was accompanied by a slowing in both price and wage increases in most major foreign economies (Chart 9). However, the decline of dollar exchange rates far

exceeded this deterioration in the relationship of price trends here and abroad and resulted in a very large gain in cost competitiveness for United States producers, compared with those of Europe and Japan.

In contrast, the sharp decline of the Canadian dollar's exchange rate in terms of United States dollars in 1977 and 1978 far outweighed the inflation differential between the two countries, which had moderately favored United States products. This deterioration in United States competitive position *vis-à-vis* Canada offset some of the gain in United States competitiveness caused by the dollar's drop against the currencies of Europe and Japan. But, even so, between the second quarter of 1977 and the fourth quarter of 1978 there was an overall improvement in United States competitiveness against the world's major trading nations of almost 10 percent on average, measured by wholesale prices adjusted for changes in exchange rates.

IMPROVING UNITED STATES TRADE PERFORMANCE. Foreign trade flows adjust to changes in international price competitiveness only with a considerable time lag. By 1978 the improvement in the competitive position of American producers that had begun in 1977 started showing up in the trade data. The change was particularly evident in figures on the volume of trade that abstract from changes in prices. The expansion in the volume of United States imports other than petroleum slowed down significantly more than the expansion in domestic activity—to about 5 percent between the last quarter of 1977 and the last quarter of 1978, from more than 13 percent the year before.

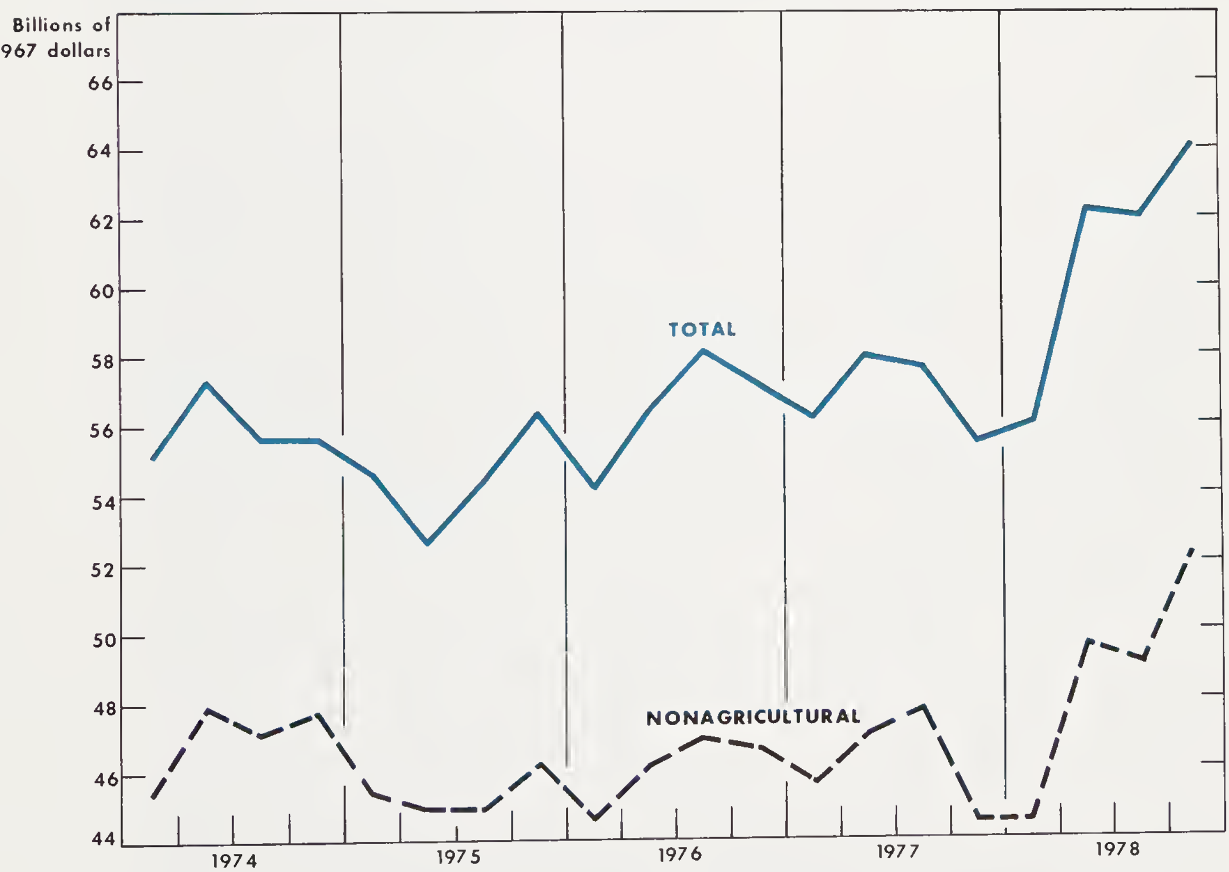
On the export side, volume growth for nonagricultural products spurted starting in the second quarter and amounted to 17 percent over the year, in contrast to the previous year's decline (Chart 10). The surge in exports was broadly represented in major categories of both consumer and producer goods, and market shares of United States exporters recovered significant ground. The volume of agricultural exports rose by 21 percent over the year, after almost no growth in 1977.

The clearest possible sign that adjustment was under way in the underlying current account position of the United States came in the improvement in the volume of exports and imports of manufactures. As a result, United States trade in manufactures recovered to a surplus in the final quarter of 1978, following a succession of deficits. Corresponding signs were seen in the slowdown in overall export volume by the major foreign surplus countries—even extending

to an outright decline for the year in Japan—and in accelerating import volumes in those economies.

The United States current account deficit settled at around a $13 billion annual rate in the last three quarters of the year, roughly half the peak rates experienced in the fourth quarter of 1977 and the first quarter of 1978. The initial perverse effect of the sharp depreciation, through the rising dollar cost of imports, offset much of the improvement in volume trends in the past year. Further improvements in the current account position may be anticipated over the next

Chart 10. UNITED STATES EXPORT VOLUME



All data are seasonally adjusted at an annual rate.

year or more, as earlier gains in competitiveness continue to affect export and import volumes and as the expansion abroad is maintained.

Strengthening the Dollar at Home and Abroad

The past year brought home to the United States the lesson long ago learned by other trading nations that the external and domestic health of a country's currency are inextricably intertwined. In the past the United States had been able to ignore this elemental truth both because its foreign trade involvement was relatively small and because it so dominated the world economy that the United States dollar was beyond questioning. By the 1970's, however, the United States economy's dependence on imports and exports had grown greatly, and the observed instability in exchange rates brought the dollar under greater scrutiny.

The dollar's travail in the last two years stems in large part from the divergence of growth rates here and abroad and from the huge burden of our petroleum imports. But inescapably it has reflected the worsening of domestic inflation and our reluctance until recently as a nation to come to grips with the problem. And, under floating rates, markets have been quick to fasten upon a country's inflation and the resolve to combat it. For the dollar, the leading currency held so widely around the world, the exposure to market pressures has been particularly great. In the event, domestic inflation and external depreciation fed upon each other to the extent that the markets began to see no end to the process, and those uncertainties in turn were undercutting the prospects for sustaining the business advance.

The measures of last November 1 marked a turning point as they demonstrated to the world that the United States was indeed determined to protect the domestic and international stability of the dollar and clearly recognized the link between the two. In one sense, the mobilizing of an array of internal and external measures to defend the dollar was not a new departure, but rather a culmination and reinforcement of earlier concerns and actions. But, in another sense, the actions did seem to represent a kind of watershed—a frank recognition that full autonomy in domestic policy is not consistent with an integrated world economy, that international money cannot be left to manage itself, that the responsibilities of the

United States for encouraging stability cannot, in its own interest, be shrugged off at the water's edge.

As so often happens, it took a looming crisis—this time in the exchange markets—to crystallize government action and to focus public attention on the need for stability. Some have interpreted the actions as adding to the risk of recession in the domestic economy; more likely, by dealing intelligently and forcefully with the major source of disturbance in the domestic economy, that risk was reduced. Perhaps more important was the frank recognition implicit in the actions that the stability of money, domestically and internationally, was crucial to the outlook for both the United States economy and the international financial system over a longer period of time.

Floating exchange rates served the world well in helping to cushion the major shocks to the international financial system in the mid-1970's. Moreover, in today's world there may be inherent advantages in a system that does not require explicit international agreement on a particular exchange rate—agreement on an "equilibrium" rate being unlikely in any event—or a rigid commitment to defend a particular rate regardless of changes in economic circumstances. But it has become equally clear that floating offers no easy, painless way of insulating a country, even one so large as the United States, from external influence. The system, like any system, can be abused—and if it is it can become a source of instability that subverts other objectives. Specifically, volatile expectations came to dominate exchange markets, and wide swings in exchange rates, instead of delivering on the promise of more autonomy for domestic monetary and other policies, have complicated domestic economic management.

The wish for greater stability will not, of course, in itself bring about the result. Nor can we expect exchange market intervention alone, however massive, to be effective. The major countries have consistently to pursue overall policies designed to bring about more stability in their economies, and they will need to maintain close cooperation among themselves as they take actions to that end, considering among other factors the implications for exchange rates.

The amended Articles of Agreement of the IMF provide a broad framework for international surveillance of that process. Consultations among the leading countries themselves, extending to the highest levels, can further it greatly. Difficult and changing questions of substance are never easily handled, however effective the consultation process. But, as 1978 ended, the imperative for the United States seemed clear enough: unwind the inflationary forces in the economy. To that end, a combination of policies is in place—a tighter wage-price

policy, a tighter budget, and tighter money.

So-called incomes policies have many serious pitfalls, as experience both here and abroad has shown. Such policies, if structured too rigidly and left for too long, have the characteristics of controls that inevitably lead to waste, inefficiency, and inequities. Often, too, they have been used as substitutes for monetary and fiscal discipline. But by 1978 inflation and expectations of inflation had come to be so built into the United States economy that normal demand restraint by itself would have taken too long to end the inflationary spiral. Used in conjunction with monetary and fiscal restraint, the current United States program of wage and price restraints can break into the wage-cost-price spiral more directly and thus act as a vital complement to the traditional efforts.

Budget deficits continue large but, as the need for fiscal discipline has become widely recognized, they are being gradually reduced. Equally important, the overall role of government spending in the economy is coming down. Cutting back the government's regulatory involvement in the economy and the cost-raising effects of other policies are also receiving increased attention.

Over the course of the recovery Federal Reserve policies, as has been the custom, have been criticized by some as too tight, by others as too easy. Be that as it may, as 1978 ended, monetary restraint was in effect and the results were beginning to show. Nevertheless, the road ahead is bound to be difficult and any progress will be hard won. But combating inflation and protecting the dollar have assumed the policy priority they deserve, and that is a necessary beginning.

Bank Supervision

During 1978 the Bank continued its efforts toward stronger and more cost-effective supervision of banks and bank holding companies. In the area of foreign lending, which had been the subject of a special Federal Reserve study in 1977, the Bank played a major role in a joint endeavor of the Federal Reserve System, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation to unify procedures for appraising country risk.

The Bank contributed substantially to the development of the Uniform Interagency Bank Rating System, a new system for employing examination data and other relevant information to measure bank financial condition. This system is expected to improve the accuracy and consistency of Federal bank examination ratings and thereby to strengthen supervision of banks. Along the same lines, the Bank helped in the formulation of a new trust department rating system adopted by the three Federal bank regulatory agencies. This Bank was also instrumental in the development of a uniform report of examination for use in on-site inspections of banks' electronic data processing functions.

In addition, the program for uniform evaluation of large credits extended jointly by commercial banks was expanded to include a significant number of international credits. This program of "shared national credits", for which this Bank maintains a computerized file used by all three Federal bank regulatory agencies, has significantly reduced bank examination time and costs. These new achievements in interagency cooperation highlight the possibilities for additional interagency programs which promote efficiency and increased cost effectiveness in Federal banking supervision.

As primary supervisor of the nation's bank holding companies, the Federal Reserve System focused its efforts on improving bank holding company inspection procedures and techniques. This Bank, having extensive experience in the supervision of large, complex banking organizations, helped develop a new uniform inspection report covering all large bank holding companies. Similarly, this Bank participated in the development of a new bank holding company rating system which is expected to provide added insight into the strengths and weaknesses of bank holding company parents, nonbank subsidiaries, and banking affiliates.

During the year, this Bank took a number of steps to improve on-site examination procedures for state member banks and bank holding companies in the Second District. The number of man-days involved in major examinations was cut substantially, while the quality of examinations was maintained through better examination techniques. By making more effective use of head office records, time spent on on-site examinations of foreign branches was shortened, which in turn enabled examining personnel to investigate additional subsidiaries and affiliates. Also, toward the end of the year, this Bank's supervisory personnel began using statistical sampling techniques to evaluate the effectiveness of commercial banks' own internal loan review programs. This program permits reduced loan review activity by field examiners when the banks' internal review programs are found to be effective.

In the field of consumer protection, this Bank completed examinations of seventy state member banks to evaluate compliance with Truth-in-Lending and related consumer protection laws and regulations, and made follow-up examinations to ensure that infractions were corrected. The Bank also conducted seminars to help banks understand and comply with consumer protection laws and regulations, and expanded its public information activities on consumer protection matters.

The supervision programs and initiatives pursued during the year aimed at safer and sounder banking without dampening the recovery prospects for the banking industry. The 1978 operating results for the District's major banking organizations suggest that substantial progress was achieved toward those twin objectives. The nine large money center banks reported an aggregate gain of nearly $300 million in net income for the year, or just over 25 percent. Reflecting improved loan experience, provisions for future loan losses declined moderately, and actual loan losses written off declined substantially. Other banks throughout the District reported sizable gains in income. On the debit side, however, capital ratios slipped somewhat at the larger organizations. All things considered, the banking industry appears to be continuing its strong rebound. Nonetheless, banks face the challenges and opportunities of major new banking legislation—the Financial Institutions Regulatory Control Act, the International Banking Act, and the Community Reinvestment Act, all enacted in 1978—which are now being implemented. It will be the task of the supervisors in the coming year to ensure that banking strength in the United States is promoted and protected in a rapidly changing financial environment.

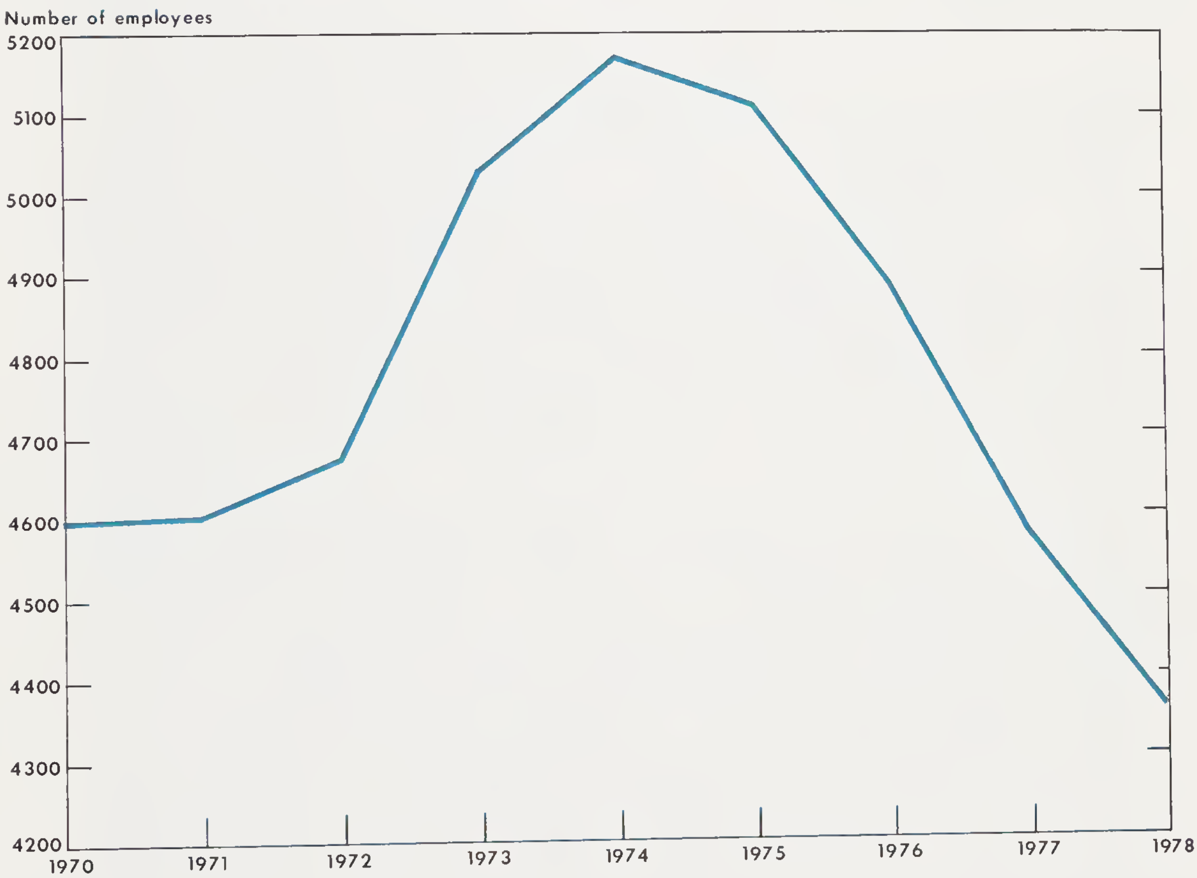
Managerial and Operational Highlights

During the year staffing at the Bank declined by 5 percent, following a reduction of 6 percent in 1977 (Chart 11). Indeed, 1978 marked the fourth consecutive year in which the size of the Bank's staff was smaller at the end of the year than at the beginning, despite steady increases in the volume and complexity of the Bank's activities.

This decrease in the Bank's work force offers perhaps the most tangible

Chart 11. **TOTAL STAFF**

Federal Reserve Bank of New York



All data are year-end levels.

evidence of the concerted efforts being made to enhance the effectiveness of the Bank's management and operations and to ensure that the Bank carries out its responsibilities for monetary policy, supervision, and banking services in the most efficient and cost-effective manner possible. Behind these reductions in staff and the accompanying increases in productivity lay a series of managerial and operational initiatives supported by the willing cooperation of an experienced staff. These initiatives included a reshaping of the Bank's basic organizational structure, introduction of a multiyear planning process, refinement of capital and expense budget and management reporting systems, development of a long-range automation strategy, and an upgrading of the Bank's physical plant and equipment.

In mid-1977, senior management had introduced a number of changes in the organizational structure of the Bank in an effort to promote "greater cohesion and more effective coordination of planning, budgeting, operations and systems analysis through closer alignment of a number of related, but organizationally separated aspects, of these activities". This organizational refinement was carried forward during 1978 with the restructuring of the Bank's management and resource planning areas and of certain control and systems development activities.

The growing administrative burdens connected with the Bank's internal planning and budgeting system, coupled with senior management's need for more timely and concise information on key operational developments, prompted a number of improvements in the Bank's management information systems during the year. In this regard, the amount of paper work associated with the internal budget process was reduced by one third, a new consolidated report on expenses, staffing, productivity, and unit costs was developed, and a systematic Bankwide program aimed at monitoring and controlling capital acquisitions was introduced.

In the area of systems development, the Bank established more comprehensive standards and management controls for the development and implementation of new processing systems and completed a reappraisal of the Bank's automation strategy which provided broad guidelines the Bank should be following in the context of current and future business needs and technology.

In 1978 the Bank developed its first integrated multiyear business plan. In broad terms, this plan seeks to identify the changes that will help improve Bank operations, strengthen the Bank's contribution to the dialogue on public policy issues, and otherwise enhance the role of the Bank and the System in the coming years.

During the year, major strides were also made in overcoming some of the

more vexing problems posed by inadequate office space and by the Bank's 56-year old physical plant. For instance, during 1978 the Bank completed the demolition, construction, outfitting, and occupancy of over 150,000 square feet of leasehold space at 59 Maiden Lane acquired in late 1977 and, at the same time, successfully completed negotiations to terminate existing leases at other locations. This resulted in a substantial consolidation of operations, improved working conditions for a large segment of the Bank's work force, and a net reduction in total costs of space.

EXPENSES AND OPERATIONS. Total expenses for 1978 grew by 3.6 percent in the face of generally higher rates of inflation of wages and prices of purchased goods and services. Over the period 1975-78, Bank expenses have grown at an annual rate of about 5 percent, in sharp contrast to the average increase of 13 percent registered in the first half of the decade.

Unit costs of operations for measured activities (which cover areas accounting for about two thirds of the Bank's expenses) declined by almost 7 percent in 1978. This decline was accompanied by marked gains in productivity in virtually all processing areas of the Bank. This, in turn, permitted a reduction in the average staff of the Bank's Operations Group by 8.5 percent.

As anticipated, some of the largest gains in productivity and unit cost savings were achieved in areas of the Bank where costs had been higher and productivity lower than in other Federal Reserve Banks. This was notably true in check processing, where physical productivity grew by more than 20 percent over 1977 levels.

The recent increase in check handling efficiency reflects the initial results of an effort aimed at bringing productivity and unit costs in line with the best in the System. This effort is based on the introduction of new computer-processing equipment and a new staffing configuration in which teams of employees will have responsibility for handling a group of checks from receipt in the Bank to ultimate disposition. This "cradle to grave" approach contrasts with the fragmented processing techniques used in the past wherein separate groups of employees were responsible for segments of the work. Early experience with this approach at the Bank's Buffalo Branch and at the Cranford, New Jersey, Regional Check Processing Center suggests that these initiatives should result in major gains in both the cost effectiveness and the quality of the Bank's check handling operations.

While the increases in check handling efficiency were the most pronounced, other processing areas of the Bank—including those which compare favorably with operations elsewhere in the Federal Reserve—also showed marked improvement in 1978. For example, in currency processing, average staffing levels were reduced by 9 percent and unit costs declined by 5 percent. These gains in the efficiency of currency handling stemmed, in large part, from the expanded use of medium-speed processing equipment which allows for batch processing of currency rather than less efficient note-by-note techniques. This mode of processing currency is an interim step pending the installation of high-speed equipment with the capability of counting, sorting fit from unfit currency, providing counterfeit detection, and destroying unfit currency. In late 1978, the Bank placed its initial orders for production models of this new equipment.

The Bank's fiscal agency operations conducted largely on behalf of the Treasury also showed sizable gains in operational efficiency in 1978. In this area—where volume increases were particularly pronounced—staff levels declined by 4.5 percent and unit costs fell by more than 10 percent. One factor contributing to the growth of volume in the fiscal area in 1978 was the high level of public participation in subscriptions to new Treasury securities, as individual investors were attracted to these instruments by higher yields.

In a number of areas of the Bank, new efforts are under way to assure that quality standards and reliability are maintained and enhanced as efficiency is improved. One priority objective is to upgrade the quality of currency placed in circulation, an effort that at times has been hampered by limits on the availability of newly printed currency. As new automated equipment becomes available to sort and destroy unfit currency with greater speed and accuracy, that effort should be enhanced.

Financial Statements

STATEMENT OF EARNINGS AND EXPENSES FOR THE CALENDAR YEARS 1978 AND 1977 (In dollars)

	1978	1977
Total current earnings	2,108,679,754	1,702,740,726
Net expenses	135,546,130	131,678,202
Current net earnings	1,973,133,624	1,571,062,524
Additions to current net earnings	361,442	3,740,033
Deductions from current net earnings:		
Loss on foreign exchange (net)★	130,971,648	37,474,391
Loss on sales of United States Government securities and Federal agency obligations (net)	31,579,498	11,783,645
All other	582,453	659,296
Total deductions	163,133,599	49,917,332
Net deductions	162,772,157	46,177,299
Assessment for the Board of Governors	13,851,000	12,048,600
Net earnings available for distribution	**1,796,510,467**	**1,512,836,625**
Dividends paid	16,518,453	15,319,899
Transferred to surplus	13,133,300	15,452,000
Payments to United States Treasury (interest on Federal Reserve notes)	1,766,858,714	1,482,064,726
SURPLUS ACCOUNT		
Surplus—beginning of year	266,708,950	251,256,950
Transferred from net earnings for year	13,133,300	15,452,000
Surplus—end of year	**279,842,250**	**266,708,950**

★ The amount shown for 1978 includes New York's share of realized losses on foreign exchange transactions of $77.0 million and unrealized losses of $54.0 million resulting from revaluing foreign exchange holdings and outstanding commitments at current market exchange rates. Of these amounts, $68.3 million and $38.9 million, respectively, reflect New York's share of losses associated with Swiss franc commitments entered into before August 15, 1971. The unrealized net loss is calculated using market exchange rates of December 29, 1978 to value the System's foreign currency holdings and foreign currency commitments; liquidation or payment may actually take place at exchange rates that differ from these rates.

STATEMENT OF CONDITION

In dollars

Assets	DEC. 31, 1978	DEC. 31, 1977
Gold certificate account	3,205,935,246	3,492,174,498
Special Drawing Rights certificate account	330,000,000	313,000,000
Coin	20,732,835	18,079,848
Total	3,556,668,081	3,823,254,346
Advances	310,780,000	102,800,000
Acceptances held under repurchase agreements	587,128,600	953,597,256
United States Government securities:		
Bought outright*	26,632,041,344	23,819,212,000
Held under repurchase agreements	1,083,900,000	1,901,000,000
Federal agency obligations:		
Bought outright	1,920,695,909	1,889,089,015
Held under repurchase agreements	133,000,000	451,000,000
Total loans and securities	30,667,545,853	29,116,698,271
Other assets:		
Cash items in process of collection	1,359,756,205	1,450,436,176
Bank premises	9,965,152	9,207,030
All other†	1,039,906,461	492,282,697
Total other assets	2,409,627,818	1,951,925,903
Interdistrict settlement account	854,493,329	(1,312,886,283)
Total Assets	**37,488,335,081**	**33,578,992,237**

* Includes securities loaned—fully secured	257,930,000	135,935,000

† Includes assets denominated in foreign currencies. The amount of such assets on December 31, 1978 reflects revaluation made at market rates as of December 29, 1978.

STATEMENT OF CONDITION

In dollars

Liabilities	DEC. 31, 1978	DEC. 31, 1977
Federal Reserve notes	26,335,259,348	23,678,138,605
Deposits:		
Member bank reserve accounts	6,884,225,999	5,783,978,634
United States Treasury—general account	1,032,980,458	1,398,528,731
Foreign	217,335,351	173,647,386
Other	814,920,098	688,984,628
Total deposits	8,949,461,906	8,045,139,379
Other liabilities:		
Deferred availability cash items	919,995,734	990,862,184
All other*	723,933,593	331,434,169
Total other liabilities	1,643,929,327	1,322,296,353
Total Liabilities	**36,928,650,581**	**33,045,574,337**
Capital Accounts		
Capital paid in	279,842,250	266,708,950
Surplus	279,842,250	266,708,950
Total Capital Accounts	**559,684,500**	**533,417,900**
Total Liabilities and Capital Accounts	**37,488,335,081**	**33,578,992,237**

* The December 31, 1978 amount includes exchange translation account balance reflecting the revaluation of outstanding foreign exchange commitments as of December 29, 1978.

Changes in Directors and Senior Officers

CHANGES IN DIRECTORS. In a special election of directors held on April 19, 1978, member banks in Group 3 elected James Whelden a Class A director for the unexpired portion of a term ending December 31, 1978. Mr. Whelden, President of the Ballston Spa National Bank, Ballston Spa, N.Y., succeeded Harry J. Taw, who resigned as a Class A director effective January 3, 1978.

In December 1978, member banks in Group 3 reelected Mr. Whelden a Class A director, and John R. Mulhearn a Class B director, both for three-year terms beginning January 1, 1979. Mr. Mulhearn, President of the New York Telephone Company, has served as a Class B director since April 15, 1977.

Also in December, the Board of Governors of the Federal Reserve System redesignated Robert H. Knight as *Chairman* of the board of directors and *Federal Reserve Agent* for the year 1979. Mr. Knight, a partner in the New York law firm of Shearman & Sterling, has been serving as a Class C director since February 1976 and as *Chairman* and *Federal Reserve Agent* since January 1978; he also served as *Deputy Chairman* in 1976 and 1977. At the same time, the Board of Governors reappointed Boris Yavitz as *Deputy Chairman* of the board of directors for the year 1979. Dr. Yavitz, Dean of the Graduate School of Business at Columbia University, has been serving as a Class C director since June 1977 and as *Deputy Chairman* since January 1978. In December the Board of Governors also reappointed Gertrude G. Michelson a Class C director for the three-year term beginning January 1, 1979. Mrs. Michelson, Senior Vice President of Macy's New York, has been serving as a Class C director since February 1978.

Buffalo Branch. In August 1978, the board of directors of this Bank appointed Robert J. Donough a director of the Buffalo Branch for the unexpired portion of a term ending December 31, 1978. Mr. Donough, President of the Liberty National Bank and Trust Company, Buffalo, N.Y., succeeded Kent O. Parmington, Regional President (Western Region) of The Bank of New York, who served as a director of the Buffalo Branch from May 1976 until his death on July 22, 1978. In December 1978, the board of this Bank reappointed Mr. Donough a Branch director for a three-year term beginning January 1, 1979. At the same time, this Bank's board of directors designated Frederick D. Berkeley as *Chairman* of the board of directors of the Buffalo Branch for the year 1979. Mr. Berkeley, who is Chairman of the Board and President of

Graham Manufacturing Co., Inc., Batavia, N.Y., has been a director of the Branch since February 1977. Also in December 1978, the Board of Governors appointed John Rollins Burwell and George L. Wessel as directors of the Buffalo Branch. Mr. Burwell, who was appointed for the unexpired portion of a term ending December 31, 1980, is President of Rollins Container Corp., Rochester, N.Y. He succeeds Paul A. Miller, President of the Rochester Institute of Technology, who resigned as a director of the Branch. Dr. Miller had been a director of the Branch since January 1975 and was *Chairman* of the Branch Board in 1977. Mr. Wessel, who was appointed for a three-year term beginning January 1, 1979, is President of the Buffalo AFL-CIO Council. He succeeds Donald R. Nesbitt, Sr., owner and operator of Silver Creek Farms, Albion, N.Y. Mr. Nesbitt had been a director of the Branch since January 1973 and was *Chairman* of the Branch Board in 1975 and 1978.

CHANGES IN SENIOR OFFICERS. The following changes in official staff at the level of Vice President and above have occurred since January 1978:

Robert E. Lloyd, Jr., Vice President, resigned from the Bank effective September 14, 1978. Mr. Lloyd had joined the Bank's staff as an officer in 1973.

Edward G. Guy, formerly Senior Vice President and General Counsel, was designated Senior Vice President and Counsel to the President, effective January 1, 1979. Effective the same date, James H. Oltman, formerly Deputy General Counsel, was appointed General Counsel.

Thomas C. Sloane, Senior Vice President and Senior Adviser, was assigned responsibility, effective January 1, 1979, for a new Administrative Services Group, consisting of the Accounting, Building Services, and Service Functions. Mr. Sloane's responsibility for the Bank Relations Office and for special studies was continued; his responsibility for consumer affairs was transferred to the Public Information Department.

Peter Fousek, formerly Vice President and Director of Research, was appointed Senior Vice President and Director of Research, effective January 1, 1979.

Scott E. Pardee, formerly Vice President, was appointed Senior Vice President, effective January 1, 1979. Mr. Pardee has supervisory responsibility for activities relating to foreign exchange operations under Alan R. Holmes, Executive Vice President.

E. Gerald Corrigan, Vice President, formerly in charge of the Management and Resource Planning Group, was assigned to the Open Market Operations and Trea-

sury Issues Function, effective January 1, 1979. In addition, Mr. Corrigan was assigned responsibility for special studies related to the securities industry. Effective the same date, Ronald B. Gray, Vice President, assumed responsibility for the Management and Resource Planning Group, and his assignment to the Bank Supervision Function was terminated.

Henry S. Fujarski, formerly Assistant Vice President, was appointed Vice President, effective January 1, 1979, and was assigned to the Accounting Function.

Ernest T. Patrikis, formerly Assistant General Counsel, was appointed Deputy General Counsel, effective January 1, 1979.

Rudolf Thunberg, formerly Assistant Vice President, was appointed Vice President and Assistant Director of Research, effective January 1, 1979.

Richard Vollkommer, formerly Assistant Vice President, was appointed Vice President, effective January 1, 1979, and was assigned to the Service Function, in anticipation of the retirement of Frederick L. Smedley, Vice President, on March 1, 1979.

Directors of the Federal Reserve Bank of New York

DIRECTORS

	Term expires Dec. 31	Class	Group
ELLMORE C. PATTERSON Former Chairman of the Board, Morgan Guaranty Trust Company of New York, New York, N.Y.	1979	A	1
RAYMOND W. BAUER Chairman and President, United Counties Trust Company, Elizabeth, N.J.	1980	A	2
JAMES WHELDEN President, Ballston Spa National Bank, Ballston Spa, N.Y.	1981	A	3
MAURICE F. GRANVILLE Chairman of the Board, Texaco Inc., White Plains, N.Y.	1979	B	1
WILLIAM S. SNEATH Chairman of the Board, Union Carbide Corporation, New York, N.Y.	1980	B	2
JOHN R. MULHEARN President, New York Telephone Company, New York, N.Y.	1981	B	3
ROBERT H. KNIGHT, *Chairman, and Federal Reserve Agent* Partner, Shearman & Sterling, Attorneys, New York, N.Y.	1980	C	
BORIS YAVITZ, *Deputy Chairman* Dean, Graduate School of Business, Columbia University, New York, N.Y.	1979	C	
GERTRUDE G. MICHELSON Senior Vice President, Macy's New York, New York, N.Y.	1981	C	

DIRECTORS—BUFFALO BRANCH

FREDERICK D. BERKELEY, *Chairman* Chairman of the Board and President, Graham Manufacturing Co., Inc., Batavia, N.Y.	1979
M. JANE DICKMAN Partner, Touche Ross & Co., Buffalo, N.Y.	1979
WILLIAM B. WEBBER Vice Chairman of the Board, Lincoln First Bank, N.A., Rochester, N.Y.	1979
WILLIAM S. GAVITT President, The Lyons National Bank, Lyons, N.Y.	1980
JOHN ROLLINS BURWELL President, Rollins Container Corp., Rochester, N.Y.	1980
ROBERT J. DONOUGH President, Liberty National Bank and Trust Company, Buffalo, N.Y.	1981
GEORGE L. WESSEL President, Buffalo AFL-CIO Council, Buffalo, N.Y.	1981

MEMBER OF FEDERAL ADVISORY COUNCIL—1979

WALTER B. WRISTON Chairman of the Board, Citibank, N.A., New York, N.Y.	1979

Officers of the Federal Reserve Bank of New York

PAUL A. VOLCKER, *President*
THOMAS M. TIMLEN, *First Vice President*

ALAN R. HOLMES, *Executive Vice President*
Foreign; Open Market Operations and Treasury Issues

PETER FOUSEK, *Senior Vice President and Director of Research*

EDWARD G. GUY, *Senior Vice President and Counsel to the President*

PAUL B. HENDERSON, JR., *Senior Vice President*
Operations Group

JAMES H. OLTMAN, *General Counsel*
Legal

SCOTT E. PARDEE, *Senior Vice President*
Foreign

FRED W. PIDERIT, JR., *Senior Vice President*
Bank Supervision

THOMAS C. SLOANE, *Senior Vice President and Senior Adviser*
Administrative Services Group; Bank Relations

PETER D. STERNLIGHT, *Senior Vice President*
Open Market Operations and Treasury Issues

AUDIT

JOHN E. FLANAGAN, *General Auditor*
FRANK C. EISEMAN, *Assistant General Auditor*
WILLIAM M. SCHULTZ, *Assistant General Auditor*
DONALD R. ANDERSON, *Manager, Auditing Department*
GERALD I. ISAACSON, *Manager, Audit Analysis Department*

ADMINISTRATIVE SERVICES GROUP

THOMAS C. SLOANE, *Senior Vice President and Senior Adviser*
LOUIS J. BRENDEL, *Adviser*

ACCOUNTING

HENRY S. FUJARSKI, *Vice President*
JOHN J. STRICK, *Manager, Accounting Department*

BUILDING SERVICES

RALPH A. CANN III, *Assistant Vice President*
MATTHEW C. DREXLER, *Manager, Building Operating Department*

SERVICE

RICHARD VOLLKOMMER, *Vice President*
CECIL A. SHEPHERD, *Assistant Vice President*
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FRANKLIN T. LOVE, *Bank Relations Officer*

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*FREDERICK C. SCHADRACK, *Vice President*
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ECONOMIC ADVISER

RICHARD G. DAVIS, *Senior Economic Adviser*

EQUAL OPPORTUNITY

RUTH ANN TYLER, *Equal Opportunity Officer*

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*On leave of absence.

Officers *(Continued)*

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GEORGE H. BOSSY, *Manager, Foreign Department*
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Gary S. Weintraub, *Operations Officer*

MANAGEMENT INFORMATION

Peter D. Luce, *Assistant Vice President and Cashier*

**On leave of absence.*

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